Supreme Court, U.S.
FILED
MAY 29 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 86-1745

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1986

FRANKLIN AND JULIA MOORE,
individually and as representatives of a class,
Petitioners,

v.

EARL R. FROST, JR. AND
BROWNFIELD, BOWEN, BALLY & STURTZ,
Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

RALPH F. MITCHELL, ESQ.
900 Central Trust Tower
5 West Fourth Street
Cincinnati, Ohio 45202
(513) 381-9200

Counsel of Record
Counsel for Respondents

OF COUNSEL:
Michael E. Maundrell, Esq.
John W. Hust, Esq.
George D. Jonson, Esq.
RENDIGS, FRY, KIELY & DENNIS
900 Central Trust Tower
5 West Fourth Street
Cincinnati, Ohio 45202
(513) 381-9200

May 28, 1987

COURT INDEX PRESS, INC. — 215 E. Ninth Street, Cincinnati, Ohio 45202 — (513) 241-1450

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	II
OPINIONS BELOW	1
STATEMENT OF THE CASE	1
REASONS FOR DENYING THE WRIT	
I. As conceded in petitioners' brief, the Sixth Circuit applied the proper standard for review in determining whether there was sufficient evidence to create a jury issue	8
II. An attorney for an issuer of securities does not have a duty to correct a material misstatement of fact contained in an offering circular he prepared, where, immediately after he learns that a statement or statements contained in the circular are false, he insists that his client conform its conduct to the representations in the offering circular	11
CONCLUSION	25

TABLE OF AUTHORITIES

Cases:	Page
Armstrong v. *McAlpin*, (2d Cir. 1983) 699 F.2d 79	10
Carter, In re:, (1979) Fed. Sec. L. Rep. (CCH) ¶ 82175	18
Carter, In re:, (1981) Fed. Sec. L. Rep. (CCH) ¶ 82847	19, 20, 21, 22, 23
Dunn Appraisal Co. v. *Honeywell Information System, Inc.*, (6th Cir. 1982) 687 F.2d 877	11
Ernst & Ernst v. *Hockfelder*, (1976) 425 U.S. 185	17
Lavender v. *Kurn*, (1946) 327 U.S. 645	9
Mansbach v. *Prescott, Ball & Turbin*, (6th Cir. 1979) 598 F.2d 1017	10
Rogers v. *Mo. Pacific R.R. Co.*, (1957) 352 U.S. 500	10
Rose v. *Arkansas Valley Envt'l & Util. Auth.*, (1983) 562 F. Supp. 1180	14, 15, 16
S.E.C. v. *Nat'l Student Marketing Corp.*, (1978) 457 F. Supp. 682	12
S.E.C. v. *Washington County*, (6th Cir. 1982) 676 F.2d 218	10
Woodward v. *Metro Bank of Dallas*, (5th Cir. 1975) 522 F.2d 84	10

OTHER AUTHORITIES

Garrett, New Directions in Professional Responsibility, (March 1974) 29 Bus. Law 7 18

No. 86-1745

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1986

FRANKLIN AND JULIA MOORE,
individually and as representatives of a class,
Petitioners,

v.

EARL R. FROST, JR. AND
BROWNFIELD, BOWEN, BALLY & STURTZ,
Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

OPINIONS BELOW

The opinion of the Court of Appeals for the Sixth Circuit is reported at 809 F.2d 297 and is reprinted in Appendix A to the Petition for a Writ of Certiorari herein.

STATEMENT OF THE CASE

A. Proceedings Below

The statement of proceedings below which appears on pages 1 and 2 of the Petition for a Writ of Certiorari filed herein is complete and accurate.

B. Statement of Facts

This case involves the activities of four Ohio corporations relating to the syndication of joint venture interests and limited partnerships in oil and gas programs in eastern Ohio during the period of 1976 through 1981. Fenex, Inc. ("Fenex") was an Ohio corporation organized in 1976 and operated as a joint venturer with various investors in oil and gas wells (Final Pretrial Statement, Stipulation of Facts ("Stipulation"), R. 123 at 11). Fenex, and the investors who joined with it in a joint venture, owned intangible working interests in oil wells, which amounted to approximately 54.76% of the income from the well (T.P., R. 193 at 525).

H.M.W. Company, Inc. ("H.M.W.") was an Ohio corporation organized in 1977. It entered into limited partnership agreements with investors in oil and gas well equipment. This equipment frequently was placed on Fenex wells in return for a portion of the production income (T.P., R. 193 at 522; 533).

Bethel Securities Company was a registered broker dealer which sold the securities issued by Fenex and H.M.W. Bethel Resources, Inc. was an affiliated contractor primarily employed to drill the wells and purchase the equipment (T.P., R. 193 at 532; 533).

The principal operating officers of these companies were Robert R. Hills and the third party defendant Rufus B. Hurst. Hills was the president of H.M.W., Bethel Resources and Bethel Securities as well as being an officer and director of Fenex. Mr. Hurst was the person principally responsible for the day to day management and administration of the companies. (Stipulation, R. 123 at 12; T.P., R. 193 at 520-21)

From 1976 until August of 1981, Frost represented Fenex, H.M.W., Bethel Resources and Bethel Securities substantially with reference to securities matters. He never served as an officer or director, nor was he ever a shareholder in any of the companies (T.P., R. 197 at 1076).

Until late August of 1980, Frost's representation of these companies was routine and uneventful. He handled the mundane legal problems common to the oil and gas business. Many of these centered around the oil and gas leases, and included title problems, delay rental problems and lapse problems (T.P., R. 197 at 1097-1105). Frost handled some minor tax problems involving personal property, franchise and federal information tax returns which the companies' outside accountant had neglected to complete (T.P., R. 197 at 106-08; T.P., R. 192 at 410-11). He also was involved in routine audits conducted by the oil and gas section of the Ohio Division of Securities. Both Frost and the Commissioner of the Ohio Division of Securities described these audits as "routine", and both testified that the Division staff was satisfied with the results of the audits (T.P., R. 198 at 1288; 1323; 1328; R. 197 at 1126-29; 1131).

On August 28, 1980, Frost met with Rufus Hurst at the company offices in connection with a routine Division audit (T.P., R. 197 at 1133-41). Because Bethel Resources was doing the drilling for Fenex, there were no internal invoices from third party contractors to show the Division that a well had been drilled as had been the case in earlier audits. Frost suggested to Hurst that they could show the Division how much they spent for drilling by comparing the budget estimate with the balance of the money in each account (T.P., R. 197 at 1136-37). Hurst informed Frost that separate Fenex accounts had not been maintained, but that all Fenex monies were being kept in a single cash management account (T.P., R. 193 at 692-93; 697-98; 706-07).

Frost was not told that the companies could not account for the investors' monies and he was specifically told that there was no problem with H.M.W. and that separate accounts were being maintained for H.M.W. offerings (T.P., R. 194 at 693; 697-98; 700; 704; T.P., R. 197 at 1140-42; 1152-53).

In the beginning of October, Frost learned for the first time that Fenex did not have enough money to complete the wells.

This was due to cost overruns. Bethel Resources had been paid to drill the wells, but due to failures in drilling and other cost overruns, it had used up the money paid by Fenex for the drilling (T.P., R. 197 at 1151-52). At that time, Frost was not aware of how much money was involved.

From August 28, 1980 through November 26, 1980, Frost prepared no further Fenex offerings. A November 26, 1980 offering was submitted only after a conference with the Division of Securities on November 13, 1980, at which time the failure to segregate monies and the shortage of cash was again disclosed to the Division (T.P., R. 194 at 711-12; T.P., R. 197 at 1156-61).

The following is a chronology of events and actions taken by Frost, subsequent to his initial discovery that monies had not been segregated:

1. At the August 28, 1980 meeting, Frost instructed Mr. Hurst to immediately place the proceeds of the Campbell-Uhler offering currently being sold into a separate account. Frost periodically and randomly checked the passbooks to insure that his instructions were being carried out. (T.P., R. 194 at 704-05; T.P., R. 197 at 1142-43; 1159).

2. Frost demanded and several days later received a meeting with Robert R. Hills, Chairman of the Board and a principal shareholder of Fenex. At that meeting Hills expressed his belief that it was not much of a problem that the money was not kept in separate accounts because all the money was in a cash management account. Frost explained, "when you make a representation in an offering circular that you are going to keep it in a separate account, you are going to keep it in a separate account." (T.P., R. 197 at 1141-42)

3. In early October of 1980, Frost learned for the first time that the companies were short money, although the amount was unknown. At that time it was believed to be a Bethel Resources, and not a Fenex, problem since

Fenex had substantial assets of approximately $1.5 million (T.P., R. 197 at 152; 1164-65).

4. After Frost learned that there was a shortage of cash he did not prepare any additional Fenex offering circulars (T.P., R. 197 at 1153).

5. Frost forthwith reported the fact of financial difficulty to the Ohio Division of Securities (T.P., R. 194 at 711-12; T.P., R. 197 at 1158; 1162).

6. Thereafter, in response to Frost's disclosure to the Division of Securities, it issued a subpoena on October 10, 1980 which the company complied with on October 23, 1980 (T.P., R. 198 at 1295).

7. Frost resumed preparation of Fenex offering circulars only after a conference with the Division of Securities on November 13, 1980 (T.P., R. 197 at 1153; 1156; 1158).

8. Frost was informed by his client that they had received an oral loan commitment from the Pittsburgh National Bank for at least $500,000. The written commitment which was received on or about November 17, 1980 was forwarded to the Division of Securities by Frost on November 20, 1980 (T.P., R. 197 at 1162).

9. After these events the Division of Securities gave the go ahead for further offerings (T.P., R. 197 at 1159-60; 1167-68).

10. Frost continued to periodically and randomly check to see that the monies were segregated in separate passbook accounts. This included personal visits to the company offices to verify segregation as well as having Mr. McQueen come to his office to show Frost passbooks. Additionally, Frost required that Mr. McQueen's signature be added to Mr. Hill's signature for transactions involving these separate accounts (T.P., R. 194 at 704; T.P., R. 197 at 1159).

11. A copy of the separate passbook account for the Campbell-Uhler package was forwarded to the Division by Frost's November 26, 1980 letter, the same letter which enclosed the documentation for the Fenex, Campbell-Gallapoo-Weekley offering, the first offering after Frost learned of and disclosed to the Division the shortage of monies (PX 150).

12. On December 3, 1980 Frost again wrote Mr. Warneka of the Division of Securities with reference to the Campbell-Gallapoo-Weekley package and the maintenance of monies in separate accounts. The Division was invited to examine the offering and confirm these facts for itself (PX 151). On December 16, 1980 Frost wrote Mr. Warneka of the Division of Securities with reference to the Miller, Sherrick and Schultz package and once again reiterated that the companies understood the Division required monies to be maintained in separate accounts (DX 411). This offering was approved by the Division on December 30, 1980 (PX 1090).

13. On January 7, 1981 Frost sent the Division of Securities additional well completion records (Marting, T.P., R. 198 at 1321).

14. On January 22, 1981 Frost received from Rufus Hurst the final calculations as to the amount of money needed by Bethel Resources to complete its obligations to Fenex and these were delivered to the Division of Securities (T.P., R. 197 at 1151; 1186; DX 426 and 427).

15. On February 4, 1981 Frost met with Mr. LeGrand of the Division of Securities and delivered additional well completion records and reported on the segregation of funds (T.P., R. 197 at 1186; PX 155).

16. On February 6, 1981 Frost wrote Mr. LeGrand following up their meeting of February 4, 1981 and produced additional records (PX 255).

17. According to Roger Marting, the Commissioner of

the Division of Securities, the Division was satisfied at that point and no further action was taken in connection with the audit (Marting, T.P., R. 198 at 1322-23).

In July of 1981, a number of events occurred which eventually led to the financial demise of Bethel Resources, and thereafter Fenex and H.M.W. In July of 1981, the Pittsburgh National Bank withdrew its written commitment to extend Bethel Resources a $500,000 to $1,000,000 line of credit. Simultaneously, Rimco cancelled its substantial drilling contracts with Bethel Resources. These two events caused approximately eighty percent (80%) of Bethel Resources' cash flow to evaporate. Unbeknownst to Frost and acting without his counsel, Hills and Hurst then pledged the assets of Bethel Resources, Fenex and H.M.W. to certain creditors of Bethel Resources in order to satisfy debts owed to them and to secure further credit. Because of the Rimco and Pittsburgh National Bank developments, Bethel Resources had no cash flow to complete turnkey drilling obligations which it owed to Fenex and H.M.W.

On learning of these events and of the fact that Fenex was failing to segregate monies raised on the only package then being offered, Frost ordered Hills and Hurst to return the money to the investors — which they did — and he resigned as counsel (R. 194 at 619-25; 630-38; 642-45; R. 195 at 838; 868-71; 887-89; R. 197 at 1186-91; 1196; 1198A-99).

REASONS FOR DENYING THE WRIT

I. As conceded in petitioners' brief, the Sixth Circuit applied the proper standard for review in determining whether there was sufficient evidence to create a jury issue.

Petitioners, in framing their first question presented state that the Sixth Circuit's standard for review of the trial court's ruling on a motion for directed verdict is in conflict with the decisions of this Court and other circuits.

However, on page 11 of their brief, petitioners concede that: "The Sixth Circuit's error was not in stating the standard for review, but in applying it." (Brief of Petitioners, at 11)

Petitioners' misleading statement of the question presented is nothing other than a patent plea to this Court to engage in a second extensive review of the record, presumably to their benefit.

After their misleading description of the question presented, petitioners embark upon a confusing and esoteric discussion of the application of the standard of review in F.E.L.A. cases. Petitioners conclude their dissertation with a sweeping statement that: ". . . the federal standard for appellate review of a denial of a directed verdict motion is in a state of conflict and confusion." (Brief of Petitioners, at 16) Respondents would submit that only the petitioners are confused.

First, the standard of review applied by the Sixth Circuit in this case is identical in substance, if not in exact language, to the standard of review applied by this Court in F.E.L.A. actions. In this case, the Sixth Circuit in its opinion set forth the standard of review as follows:

> In considering a motion for a directed verdict under rule 50(a), the trial court "must determine whether there was sufficient evidence presented to raise a material issue

> of fact for the jury." *O'Neill* v. *Kiledjian*, 511 F.2d 511, 513 (6th Cir. 1975). As applied in this context, "sufficient evidence" is such that, when viewed in the light of those inferences most favorable to the nonmovant, . . . there is either a complete absence of proof on the issues or no controverted issues of fact upon which reasonable [minds] could differ.

809 F.2d at 303.

Hence, the Sixth Circuit described two yardsticks by which a court must measure whether there is a lack of evidence sufficient to raise a material issue of fact for the jury: (1) a complete absence of proof; or (2) an absence of controverted issues of fact upon which reasonable minds could differ. Compare this language with this Court's description of the standard of review in *Lavender* v. *Kurn* (1946) 327 U.S. 645:

> . . . Whenever facts are in dispute or the evidence is such that fair-minded men may draw different inferences, a measure of speculation and conjecture is required on the part of those whose duty it is to settle the dispute by choosing what seems to them to be the most reasonable inference. Only when there is a complete absence of probative facts to support the conclusion reached does a reversible error appear.

327 U.S. at 653.

Respondents also would point out to the Court that the standard for reveiw for directed verdict must be viewed in the context of the particular type of action. Certainly it is no coincidence that petitioners chose to rely upon F.E.L.A. cases wherein this standard was applied. The degree of proof required in an F.E.L.A. case as contrasted with that required in a case involving common law fraud and aiding and abetting a violation of Rule 10b-5 are quite different.[1]

---

[1] Further, respondents question what prejudice petitioners suffered in this case. Petitioners had the benefit of a standard for review most favorable to their position.

As this Court noted in *Rogers* v. *Mo. Pacific R.R. Co.*, (1957) 352 U.S. 500, 506:

> Under this statute [F.E.L.A.] the test of a jury case is simply whether the proofs justify with reason the conclusion that employer negligence played any part, *even the slightest*, in producing the injury or death for which damages are sought. (emphasis supplied)

The quantum of proof in a 10b-5 case differs dramatically. To establish proof against a party as an aider and abettor, plaintiff must establish three elements:

1. A primary party has committed a securities law violation;
2. The aider and abettor had a general awareness that his role was part of an overall activity that was improper; and
3. The alleged aider and abettor knowingly and substantially assisted the violation.

S.E.C. v. *Washington County*, (6th Cir. 1982) 676 F.2d 218, 224.

Most of the circuits have held that the *scienter* element of an aiding and abetting violation can be satisfied by a showing of "recklessness". The Sixth Circuit has defined recklessness as: ". . . highly unreasonable conduct which is an extreme departure from the standards of ordinary care." *Mansbach* v. *Prescott, Ball & Turbin*, (6th Cir. 1979) 598 F.2d 1017, 1025. *See, e.g., Armstrong* v. *McAlpin*, (2d Cir. 1983) 699 F.2d 79, 91; *Woodward* v. *Metro Bank of Dallas*, (5th Cir. 1975) 522 F.2d 84.

Further, in cases involving nondisclosure, inaction and/or silence, the Sixth Circuit has held that there must be proof that the conduct of the accused aider and abettor ". . . was *consciously* intended to aid the securities law violation." *Washington County, supra*, 676 F.2d at 226.

Similarly, in an action for common law fraud under Ohio law, the representation must be false and material and it must be made with knowledge of its falsity and with intent to mislead the other party into relying upon it. *Dunn Appraisal Co.* v. *Honeywell Information Systems, Inc.*, (6th Cir. 1982) 687 F.2d 877.

As pointed out by petitioners in their brief, the Sixth Circuit applied the correct standard for review. Respondents submit that the court applied the standard properly, particularly when viewed in the context of the type of claims involved in the within action.

II. An attorney for an issuer of securities does not have a duty to *correct* a material misstatement of fact contained in an offering circular he prepared, where, immediately after he learns that a statement or statements contained in the circular are false, he insists that his client conform its conduct to the representations in the offering circular.

Contrary to the facts stated on page 17 of petitioners' Petition for a Writ of *Certiorari*, on August 28, 1980, Mr. Frost learned that the company had failed to maintain separate accounts with reference to *Fenex* offerings only. He was specifically informed that there was no problem with H.M.W. and that separate accounts were being maintained for H.M.W. offerings. (T.P., R. 194 at 693; 697-98; 700; 704; T.P., R. 197 at 1140-42; 1152-53) On August 28, 1980, when Mr. Frost learned of this failure to maintain separate Fenex accounts, one Fenex package was being offered for sale to investors. Frost instructed Mr. Hurst to immediately place the proceeds of that offering package (Campbell-Uhler) into a separate account. Frost periodically and randomly checked the passbooks to insure that his instructions were being carried out. (T.P., R. 194 at 704-05; T.P., R. 197 at 1140-42; 1159)

Under these circumstances, the trial court held that Frost was under no duty to correct the offering circular most recently issued (Campbell-Uhler). (C.A. Opinion, at 17)

On appeal, petitioners' second issue presented for review was:

> Is an attorney liable for participating in or aiding and abetting securities laws violations after the attorney has actual knowledge that registration statements and prospectuses, which he prepared for ongoing offerings, contain omissions and misstatements of material facts, but the attorney does not advise the issuer to offer rescission, sticker offering circulars, or suspend the offerings?

Brief of Appellants, Franklin and Julia Moore in the Sixth Circuit Court of Appeals, at 25.

In support of its position on this issue, petitioners cited and discussed the same cases they cite herein, *S.E.C.* v. *Nat'l Student Marketing Corp.*, (1978) 457 F. Supp. 682 and *Rose* v. *Arkansas Valley Envt'l & Util. Auth.*, (1983) 562 F. Supp. 1180.

In *NSMC*, counsel for two public corporations which were planning to merge discovered that the net income of the acquiring corporation had been materially overstated in the financial statements distributed to the shareholders prior to their voting on the approval of the merger. This discrepancy in the financial statements was discovered prior to the closing of the merger by counsel for both corporations. The closing went forward and the financial overstatement was not disclosed to the former shareholders of the acquired corporation, the S.E.C. or the general public. Additionally, neither attorney withdrew their legal opinions prior to the merger closing. The S.E.C. brought an action for injunctive sanctions against the former president of the merged corporation and counsel for the merged corporation. The Commission's allegations of aiding and abetting against counsel for the merged corporation fell into four categories:

(1) The failure of the attorney defendants to take any action to interfere in the consummation of the merger;

(2) The issuance by the attorneys of an opinion with respect to the merger;

(3) The attorneys' subsequent failure to withdraw that opinion and inform the Interstate shareholders or the S.E.C. of the inaccuracy of the nine month financials; and

(4) The issuance by the attorneys and (the president of the merged corporation) of an opinion and letter, respectively, concerning the validity of the stock sales under Rule 133.

457 F. Supp. at 712.

The court, in discussing these allegations, stated:

> The major problem arising with regard to the Commission's contention that the attorneys failed to interfere in the closing of the merger is whether inaction or silence constitutes substantial assistance. While there is no definitive answer to this question, courts have been willing to consider inaction as a form of substantial assistance when the accused aider and abettor had a duty to disclose.
>
> * * *
>
> Upon receipt of the unsigned comfort letter, it became clear that the merger had been approved by the Interstate shareholders on the basis of materially misleading information. In view of the obvious materiality of the information, especially to attorneys learned in securities law, the attorneys' responsibilities to their corporate client required them to take steps to insure that the information would be disclosed to the shareholders. However, it is unnecessary to determine the precise extent of their obligations here, since it is undisputed that they took no steps whatsoever to delay the closing pending disclosure to and resolicitation of the In-

> terstate shareholders. But, at the very least, they were required to speak out at the closing concerning the obvious materiality of the information and the concomitant requirement that the merger not be closed until the adjustments were disclosed and approval of the merger was again obtained from the Interstate shareholders. Their silence was not only a breach of this duty to speak, but in addition lent the appearance of legitimacy to the closing. The combination of these factors clearly provided substantial assistance to the closing of the merger.

Id. at 713, 714.

Rose v. *Arkansas Valley Envt'l & Util. Auth.* centers around the issuance of certain revenue bonds. (1983) 562 F. Supp. 1180. Attorney Rausch acted as bond counsel and issued a bond opinion which was necessary in issuing and marketing the bonds. The matter was before the District Court on the motions to dismiss of Rausch and a co-defendant. Rausch attacked the sufficiency of the complaint as the allegations against him dealt solely with "omissions" and there was no allegation of the existence of any "duty" on his part to disclose such omitted matters. Rausch contended that he had no duty to disclose the omitted matters since he had no preexisting relationship of trust and confidence with the petitioners.

In its discussion of Rausch's duty, the court stated:

> As concerns traditional liability under 10b-5, there are in reality several ways in which a "duty" owed directly by a defendant to a plaintiff may come into being. The first, and most basic, of those situations exists whenever a defendant undertakes the affirmative act of communicating or disseminating information (which in this context refers to any form of communication or dissemination), with an intent, knowledge or awareness that the information will be communicated or disseminated to persons such as the plaintiff and will or may be utilized by them in connection with a purchase

or sale of a security. There is in such instances obviously a general obligation, or "duty", to speak truthfully; or, alternatively stated, a "duty" not to communicate something which is known to be untrue (or, perhaps, in which the defendant has so little basis for honest belief that the requisite degree of "recklessness" is involved). And encompassed within that general obligation is also an obligation or "duty" to communicate any additional or qualifying information, then known, the absence of which would render misleading that which was communicated. While this latter "duty" might loosely be described as a "duty to disclose," I would prefer, for purposes of distinguishing it from a true "duty to disclose," situation, dealt with below, to label it as a "duty not to omit." In reality, it is simply one facet of the general obligation to speak truthfully, arising out of and because of an affirmative act by the defendant in communicating. There is, of course, nothing new or startling in this concept; it is expressed in the literal terms of Rule 10b-5(b) itself, and has long been an integral part of the law of common law fraud and deceit.

At the opposite end of the spectrum, as I would rationalize the cases, is a different sort of "duty," which arises in true "non-disclosure" situations. In these instances there has been no affirmative act of communication by the defendant to the plaintiff which triggers an obligation on the defendant's part. The defendant's "duty" here, instead, is a matter which arises solely by virtue of some pre-existing special relationship with the plaintiff; and is what in some respects might be more accurately referred to as a "duty to come forward." It was this sort of "duty" with which the Supreme Court was concerning in *Chiarella*. As the Court held there, it exists only when there is "a relationship of trust and confidence between the parties." An example may be seen in *Bartels* v. *Algonquin Properties, Ltd.*, 471 F. Supp. 1132, 1147 (D.Vt. 1979) (general partners' relationship to limited partners).

> Midway between these two extremes may be seen yet a third situation in which a "duty" on the part of the defendant can arise. Involved here are instances where the defendant, in good faith, has communicated or disseminated information which later becomes known to him to have been false or misleading when made. In these situations, where the newly discovered information has a direct bearing upon the information previously given, the defendant has a "duty" to communicate the new information. As may be seen, this particular variety of "duty" combines certain features of both those outlined above. Analytically, it may be said to arise not because of any independent, personalized relationship of trust and confidence between the defendant and the plaintiff, but rather because of the defendant's prior affirmative act of communication. On the other hand, performance of the duty requires a further affirmative act of the defendant, in correcting the information previously conveyed, and the duty itself actually arises, and can be breached, only at such later time following the original communication as the defendant learns of the newly discovered information. For convenience sake, I would denominate this sort of "duty" as a "duty to correct."

Id. at 1206-08 (citations omitted).

The court went on to hold that since the allegations against Rausch did not arise out of a true nondisclosure situation, a preexisting relationship of "trust and confidence" was not required. Rather, Rausch had a duty to communicate the new information which affected his prior communications.

The instant case differs from both *NSMC* and *Rose*. Unlike the attorneys in *NSMC*, Mr. Frost had no fiduciary duty to petitioners.

In *Rose*, the attorney had issued an opinion which he failed to correct. In the instant case, Frost issued no opinion. Frost prepared an offering circular for his client which was true

and complete to the best of his knowledge at the time it was drafted. When he later learned that certain representations contained in the offering circular were not accurate, he took steps to put the issuer in compliance with the offering circular by instructing the issuer to place the money in a separate account. He further monitored the issuer's compliance with his instructions and reported the matter to the regulatory authority, the Ohio Division of Securities, and suspended further offerings. The Sixth Circuit, in addressing this issue, stated:

> In the instant case, we see no need to establish a hard and fast rule that an attorney has a duty to correct an offering circular when the attorney learns of a misrepresentation contained in the circular. Here, it is undisputed that Frost insisted that the funds collected at the time be maintained in separate accounts. Moreover, he periodically checked to make sure that the funds were being properly held. It is also uncontroverted that the funds collected from this offering and subsequent offerings were maintained as represented until the late spring or summer of 1981. In other words, rather than advising his clients to correct the offering circular, Frost insisted that his clients comply with the representations made in the offering circulars. Accordingly, we decline to hold Frost liable under these circumstances.

As petitioners properly state, the purpose behind the federal securities laws is to "provide investors with full disclosure of material information" and to "protect investors against manipulation of stock prices." *Ernst & Ernst* v. *Hochfelder*, (1976) 425 U.S. 185, 195. Petitioners, in their Petition, state "[T]he Sixth Circuit substituted a new duty 'to insist on compliance' for the traditional disclosure requirements of the federal securities laws." Petitioners' argument is nothing more than semantics. The court in *Rose* enunciated a "duty to correct" prior communications where they are later found to be inaccurate. Logically, a representation made may be cor-

rected in one of two ways. The communication itself may be modified to reflect the true state of affairs or, the true state of affairs may be modified to accurately comply with the representations previously made. In the instant case, Frost "corrected" the discrepancy between the facts and the representations, by forcing his client to modify its actions to comply with the representations made in the offering circular. The Sixth Circuit has not "substituted" a new duty. Rather, the Sixth Circuit has recognized that a duty to correct may be fulfilled in two ways.

Petitioners state that:

> [T]he securities attorney is faced with two irreconcilable interests: (1) the desire to avoid S.E.C. prosecution and private actions under the federal securities laws for failing to protect society's interest in assuring that innocent third parties are not victimized, and (2) the desire to act in accordance with legal professional standards that demand the protection of a client's confidences.

Petitioners' Petition, at 26.

In the instant case, Mr. Frost was never investigated or prosecuted by the S.E.C. and has acted in accordance with the legal professional standards governing his conduct while serving his clients.

In support of its contention that the S.E.C. has promulgated a separate standard of conduct for securities attorneys, petitioners cite a 1974 law review article, (Garrett, *New Directions in Professional Responsibility*, (March 1974) 29 Bus. Law 7), and the 1978 case of *National Student Marketing Corp.* However, the Commission's opinion in the case of *In re: Carter* belies petitioners' contentions. In *In re: Carter*, (1979) Fed. Sec. L. Rep. (CCH) ¶ 82,175, the S.E.C. invoked Rule 2(e) to determine whether attorneys Carter and Johnson should be suspended from practicing before the Commission. The Office of General Counsel's (OGC) allegations against the attorneys revolved around the representation of National Telephone Company. The OGC charged that the

attorneys did not reveal pertinent financial data which indicated a deteriorating financial condition. The OGC charged the attorneys with having willfully violated, and with aiding and abetting violations of §§ 10(b) and 13(a) of the Securities Exchange Act of 1934, and Rules 10b-5, 12b-20 and 13a-11. *Id.* at ¶ 82,180. The OGC also charges that the attorneys did not possess the requisite qualifications to practice before the Commission in the representation of clients and that they had engaged in unethical and improper professional conduct.

The Administrative Law Judge found that the attorneys had notice of their clients' noncompliance with the securities laws and indifference to the attorneys' advice concerning disclosure, and found that as a result of this notice they had a duty to take action, but instead continued to assist their clients in committing the violations. The Administrative Law Judge found that the attorneys had violated §§ 10(b) and 13(a) of the 1934 Act as well as Rules 10b-5, 12b-20 and 13a-11 and had, therefore, performed in an unprofessional and unethical manner. Pursuant to Rule 2(e), the attorneys were suspended from appearing or practicing before the Commission.

The attorneys appealed the ruling of the Administrative Law Judge and the Commission dismissed the findings of securities laws violations and dismissed the findings of unethical or improper professional conduct. *In re: Carter*, (1981) Fed. Sec. L. Rep. (CCH) ¶ 82,847.

In discussing the Administrative Law Judge's finding that the attorneys had failed to carry out their professional responsibilities with respect to appropriate disclosure of material facts, the Commission stated:

> Respondents argue that the Commission has never promulgated standards of professional conduct for lawyers and that the Commission's application in hindsight of new standards would be fundamentally unfair. Moreover, even if it is permissible for the Commission to apply—without specific adoption or notice—generally

recognized professional standards, they argue that no such standards applicable to respondents' conduct existed in 1974-75, nor do they exist today.

We agree that, in general, elemental notions of fairness dictate that the Commission should not establish new rules of conduct and impose them retroactively upon professionals who acted at the time without reason to believe that their conduct was unethical or improper. At the same time, however, we perceive no unfairness whatsoever in holding those professionals who practice before us to generally recognized norms of professional conduct, whether or not such norms had previously been explicitly adopted or endorsed by the Commission. To do so upsets no justifiable expectations, since the professional is already subject to those norms.

The ethical and professional responsibilities of lawyers who become aware that their client is engaging in violations of the securities laws have not been so firmly and unambiguously established that we believe all practicing lawyers can be held to an awareness of generally recognized norms. *We also recognize that the Commission has never articulated or endorsed any such standards.* That being the case, we reverse the Administrative Law Judge's findings under subparagraph (ii) of Rule 2(e)(1) with respect to both respondents. Nevertheless, we believe that respondents' conduct raises serious questions about the obligations of securities lawyers, and the Commission is hereby giving notice of its interpretation of "unethical or improper professional conduct" as that term is used in Rule 2(e)(1)(ii).

Id. at ¶84,169-70.

. . .

While precise standards have not yet emerged, it is fair to say that there exists considerable acceptance of the proposition that a lawyer must, in order to discharge

his professional responsibilities, make all efforts within reason to persuade his client to avoid or terminate proposed illegal action.

Id. at ¶ 84,170.

. . .

The securities lawyer who is an active participant in a company's ongoing disclosure program will ordinarily draft and revise disclosure documents, comment on them and file them with the Commission. He is often involved on an intimate, day-to-day basis in the judgments that determine what will be disclosed and what will be withheld from the public markets. When a lawyer serving in such a capacity concludes that his client's disclosures are not adequate to comply with the law, and so advises his client, he is "aware", in a literal sense, of a continuing violation of the securities laws. On the other hand, the lawyer is only an adviser, and the final judgment—and, indeed, responsibility—as to what course of conduct is to be taken must lie with the client. Moreover, disclosure issues often present difficult choices between multiple shades of gray, and while a lawyer's judgment may be to draw the disclosure obligation more broadly than his client, both parties recognize the degree of uncertainty involved.

Id. at ¶ 84,171.

. . .

C. "*Unethical or improper Professional Conduct.*" The Commission is of the view that a lawyer engages in "unethical or improper professional conduct" under the following circumstances: When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy

those disclosure requirements, his continued participation violates professional standards *unless he takes prompt steps to end the clent's* [sic] *noncompliance*. The Commission has determined that this interpretation will be applicable only to conduct occurring after the date of this opinion.

We do not imply that a lawyer is obliged, at the risk of being held to have violated Rule 2(e), to seek to correct every isolated disclosure action or inaction which he believes to be a variance with applicable disclosure standards, although there may be isolated disclosure failures that are so serious that their correction becomes a matter of primary professional concern. It is also clear, however, that a lawyer is not privileged to unthinkingly permit himself to be co-opted into an ongoing fraud and cast as a dupe or a shield for a wrongdoing client.

Initially, counselling accurate disclosure is sufficient, even if his advice is not accepted. But there comes a point at which a reasonable lawyer must conclude that his advice is not being followed, or even sought in good faith, and that his client is involved in a continuing course of violating the securities laws. At this critical juncture, the lawyer must take further, more affirmative steps in order to avoid the inference that he has been co-opted, willingly or unwillingly, into the scheme of non-disclosure.

The lawyer is in the best position to choose his next step. Resignation is one option, although we recognize that other considerations, including the protection of the client against forseeable [sic] prejudice, must be taken into account in the case of withdrawal. A direct approach to the board of directors or one or more individual directors or officers may be appropriate; or he may choose to try to enlist the aid of other members of the firm's management. What is required, in short, is some prompt action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying

problem, rather than having capitulated to the desires of a strong-willed, but misguided client.

Id. at ¶ 84,172 (emphasis added).

. . .

D. *Conclusion*. As noted above, because the Commission has never adopted or endorsed standards of professional conduct which would have applied to respondents' activities during the period here in question, and since generally accepted norms of professional conduct which existed outside the scope of Rule 2(e) did not, during the relevant time period, unambiguously cover the situation in which respondents found themselves in 1974-75, no finding of unethical or unprofessional conduct would be appropriate. That being the case, we reverse the findings of the Administrative Law Judge under Rule 2(e)(1)(ii). In future proceedings of this nature, however, the Commission will apply the interpretation of subparagraph (ii) of Rule 2(e)(1) set forth in this opinion.

Id. at ¶ 84,173.

It is clear that Frost has fulfilled the requirements of the S.E.C. as stated in *In re: Carter* as he took "prompt steps to end the clients noncompliance". Frost was not confronted with the situation presented in *NSMC* and *Rose* involving a client about to commit a fraud, but rather, with the matter of a client keeping funds in the wrong type of bank account. Frost learned on August 28, 1980, when only one package was being offered for sale, that Fenex funds were being kept in a cash management account and not in separate accounts as had been represented. Thereafter, the funds were placed in a separate account and Frost's clients verified this to him, thus ending the noncompliance. Frost's efforts to insure compliance did not stop there. He periodically and randomly monitored his clients' compliance; he reported the facts to the regulatory authority and he suspended further offerings.

Petitioners' second question presented is:

> Does an attorney for an issuer of securities have a duty to correct material misstatements of fact in offering circulars he prepared for ongoing offerings, after he learns the statements he made are false and misleading.

Petitioners' Petition for a Writ of *Certiorari*, at 17.

The answer to that question is clearly yes. From a review of *Rose* v. *Arkansas Valley Envt'l & Util. Auth.* and the Sixth Circuit's opinion below, it is clear that an attorney does have a duty to correct information which he has communicated or disseminated which he later learns was false when made. It is also clear from the Sixth Circuit's decision below that his duty to correct may be fulfilled by either modifying the representations made or modifying the client's conduct to conform with the representations.

The discussion of the code of professional responsibility and the "position" which petitioners allege the S.E.C. has taken, is meaningless in the instant case. Mr. Frost was not prosecuted by the S.E.C. nor the Ohio State Bar Association for his actions. Further, neither the code of professional responsibility nor the S.E.C.'s standards for prosecuting Rule 2(e) violations establish the parameters of an attorney's civil liability as an aider and abettor of securities violations. Mr. Frost's defense at trial did not include a claim that he was unable to correct the offering circular or communicate with the regulatory authorities due to the code of professional responsibility. In fact, Mr. Frost disclosed all of the pertinent facts to the Ohio Division of Securities with the knowledge and consent of his clients. Under these circumstances, the alleged conflict between the code of professional responsibility and the S.E.C.'s "position" does not impact this case in any fashion and petitioners are apparently requesting this Court to issue an advisory opinion.

CONCLUSION

"The review of Writ of *Certiorari* is not a matter of right, but of judicial discretion, and will be granted only when there are special and important reasons therefor." Rule 17, Rules of the Supreme Court of the United States. Petitioners have failed to point out any special and important reasons which would compel this Court to review the instant case and from a review of the record and the decision below, it is clear that no such reasons exist. Accordingly, the Petition for Writ of *Certiorari* is not well taken and should be denied.

Respectfully submitted,

Ralph F. Mitchell, Esq.
RENDINGS, FRY, KIELY & DENNIS
900 Central Trust Tower
5 West Fourth Street
Cincinnati, Ohio 45202
(513) 381-9200

Counsel of Record
Counsel for Respondents